EXECUTIVE SECRETARIAT
ROUTING SLIP

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI				
2	DDCI				
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA				
7	DDO				
8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/Pers				
14	D/OLL				
15	D/PAO				
16	SA/IA				
17	AO/DCI				
18	C/IPD/OIS				
19	NIO/Econ		✓		
20					
21					
22					

SUSPENSE ____________ Date

Remarks

[redacted] STAT

Executive Secretary

9/5/84
Date

3637 (10-81)

THE WHITE HOUSE
WASHINGTON

Executive Registry
84- 8056

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 9/4/84 Number: 169051CA Due By:

Subject: Cabinet Council on Economic Affairs Planning Meeting - September 6
8:45 a.m. - Roosevelt Room TOPIC: Financial Mkt. Developments

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☐	☑
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
NASA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
	☐	☐
	☐	☐
	☐	☐
Baker	☑	☐
Deaver	☐	☑
Darman *(For WH Staffing)*	☑	☐
Mc Farlane	☐	☑
Svahn	☑	☐
Chapman	☐	☑
	☐	☐
	☐	☐
	☐	☐
	☐	☐
Executive Secretary for:		
CCCT	☐	☐
CCEA	☑	☐
CCFA	☐	☐
CCHR	☐	☐
CCLP	☐	☐
CCMA	☐	☐
CCNRE	☐	☐

REMARKS:

There will be a CCEA Planning Meeting on Thursday, September 6, 1984, at 8:45 a.m. in the Roosevelt Room.

The agenda and background paper are attached.

DCI EXEC REG

L-3003

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for C[illegible]

☐ Don Clarey ☑ Tom Gibson ☐ Larry Herbolsheimer
Associate Director

THE WHITE HOUSE

WASHINGTON

September 4, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the September 6 Meeting

The agenda and papers for the September 6 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider the report of the Working Group on Financial Market Developments. The members of the Working Group has prepared three papers. The first, from William Poole, provides a "Financial Markets Update." He reviews what has happened to interest rates and stock prices since the last update on June 21. He also discusses the current forces operating on the markets.

The second paper, prepared by Gregory Ballentine, deals with "Inflation, the Cycle, and the Dollar." It concentrates on what generally occurs in inflation patterns over the course of a business cycle and on the impact of the strength of the dollar on recent levels of inflation.

The third paper, by Beryl Sprinkel, reviews "The Outlook for the Economy and Monetary Policy."

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

September 6, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments (CM# 111)

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D. C. 20500

~~MARTIN FELDSTEIN, CHAIRMAN~~
WILLIAM A. NISKANEN
WILLIAM POOLE

August 31, 1984

MEMORANDUM TO CCEA

FROM: William Poole W.P.

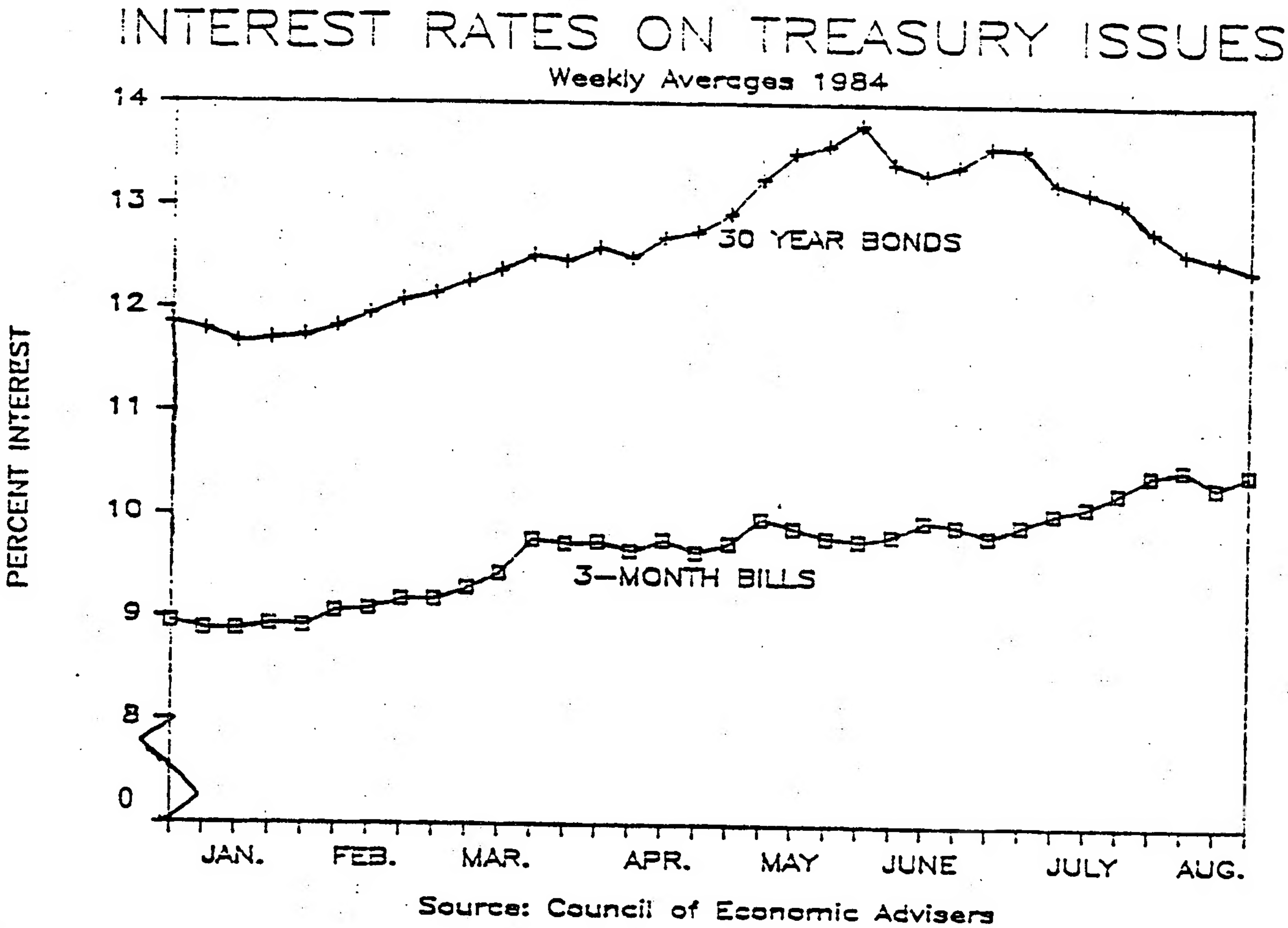
SUBJECT: Financial Markets Update

Since our last financial markets update on June 21 the big news in the credit markets is that there isn't much news. Much of the bond market nervousness apparent in the spring has disappeared. The stock market surged dramatically in early August, but otherwise has been fairly stable. These developments reflect an underlying economic environment that the the markets perceive to be relatively stable.

Interest Rates

The chart below shows the weekly average 3-month Treasury bill rate and 30-year Treasury bond yield from January through August of this year. The bill rate rose by about 80 basis points from early January to late May and by another 70 basis points to late August. In contrast, the bond yield rose by 200 basis points from January to late May -- an unusually large increase relative to the magnitude of the bill rate increase. Since late May a more normal bill-bond yield relationship has been restored as the bond yield declined by about 140 basis points from late May to late August. The net change from early January to late August is that bills are up by about 150 basis points and bonds by about 55 basis points.

The increase in the bill rate since late May overstates the upward pressure on the short end of the market. The Continental Illinois Bank problems produced a minor "flight to quality" that held the bill rate down in May. As the markets have steadied that phenomenon has largely disappeared. By late August the rates on CDs and commercial paper were at or below their levels in early July. The prime rate, at 13.00 percent, hasn't changed since late June.



Taking the January-August period as a whole, the flattening of the yield curve is a sign that market appraisals of the future are becoming more stable. As noted, from January to August the increase in the bond yield was about one-third the increase in the bill yield. In contrast, over the same months of 1983 the bond yield rose by 166 basis points while the bill rate was rising by 148 basis points. Experience this year is a return toward the historical norm and away from the almost one for one yield changes in the short and long markets that characterized most of the period from 1979 to 1983.

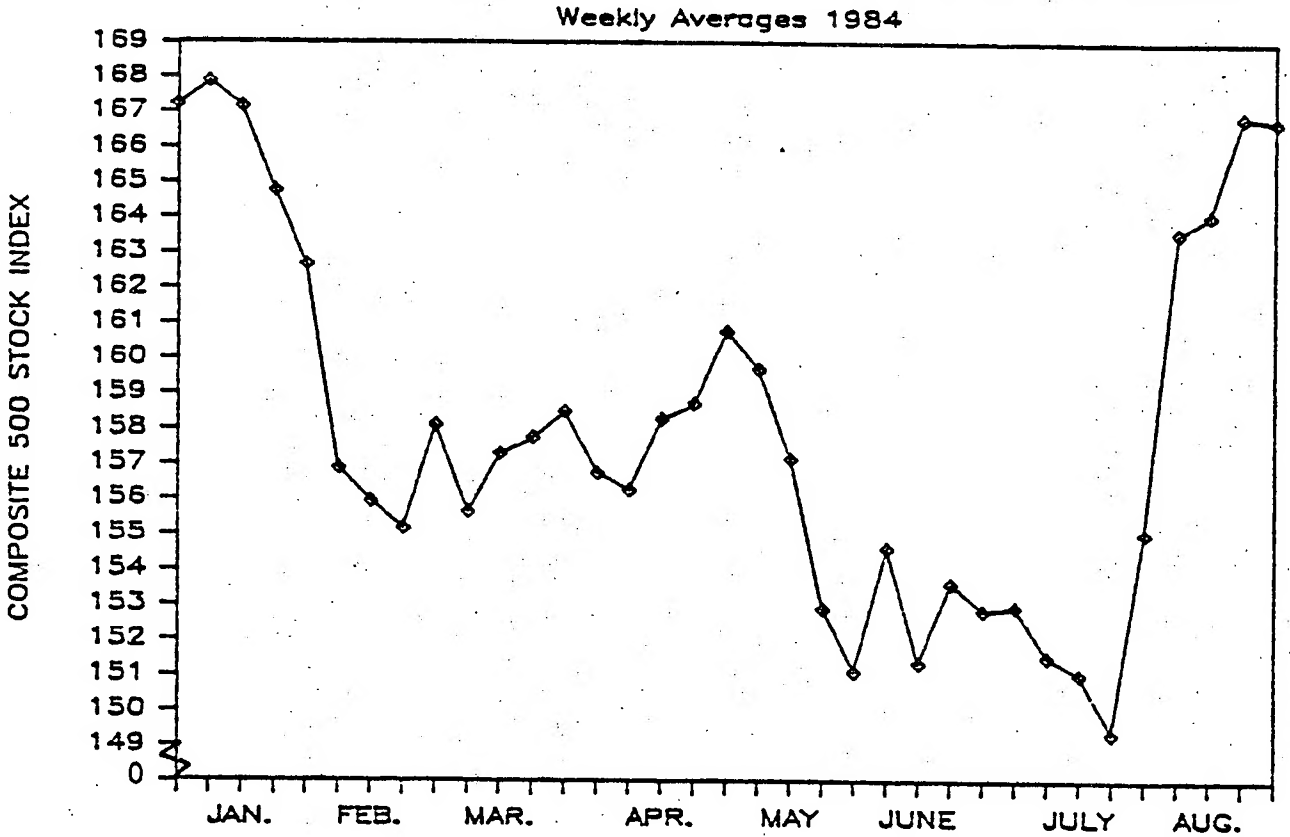
Yields on fixed rate home mortgages have been rising most of the year, reflecting the usual lag behind long-term bond yields. However, with bond yields declining significantly starting in early July, mortgage rates first leveled off in July and then declined in August.

Stock Prices

From January through late July stock prices fluctuated irregularly downward. The first three days of August saw an explosive rise in stock prices on extremely heavy volume. Some further gains occured over the rest of August, taking broad stock price indexes back to their January levels.

STANDARD & POOR'S STOCK INDEX

Weekly Averages 1984



Source: Council of Economic Advisers

Forces Operating on the Markets

Neither the timing nor the magnitude of the early August surge in the stock maket can be explained. But, in general, both the bond and stock markets seem to be responding to the following economic forces:

- o Economic data indicating a slower pace of expansion reduce fears that higher credit

will push interest rates up. Such news also reduces concerns that the Federal Reserve will tighten monetary policy by pushing rates up.

- Slower money growth suggests that the Federal Reserve has no compelling reason to push interest rates up.

- Federal Reserve statements are examined closely for clues as to the Fed's analysis of the economic situation and the Fed's policy intentions. In July the Fed's mid-year economic report was greeted positively because it seemed to promise no immediate tightening of monetary policy. Conversely, the FOMC's July Policy Record released in late August produced a minor upward blip in interest rates because it seemed to lower the odds that monetary poicy might be eased in coming months.

The net effect of the stream of economic data releases, statements by public officials, and moderating growth in credit demands has been to produce the market behavior outlined earlier in this memorandum. As noted above, the only noteworthy features of the recent course of interest rates are the greater stability in the credit markets and the substantial reversal of the run-up in bond yields that occurred between January and late May.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

August 30, 1984

MEMORAMDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: J. Gregory Ballentine

SUBJECT: Inflation, the Cycle, and the Dollar

Recent Inflation Figures

o In comparison with the inflation rates of the late 1970s and 1980, the recent inflation figures have been very good.

-- The GNP deflator for Q2/84 rose at an annual rate of 3.2%. In Q1/84 and Q4/83 the deflator rose 4.4%.

-- The CPI has risen 4.2% over the last 12 months and the monthly rate (annualized) for July is only 3.7%.

o Overall, these figures give a picture of approximately 4% inflation.

o These recent numbers must however be interpreted in light of many factors, including:

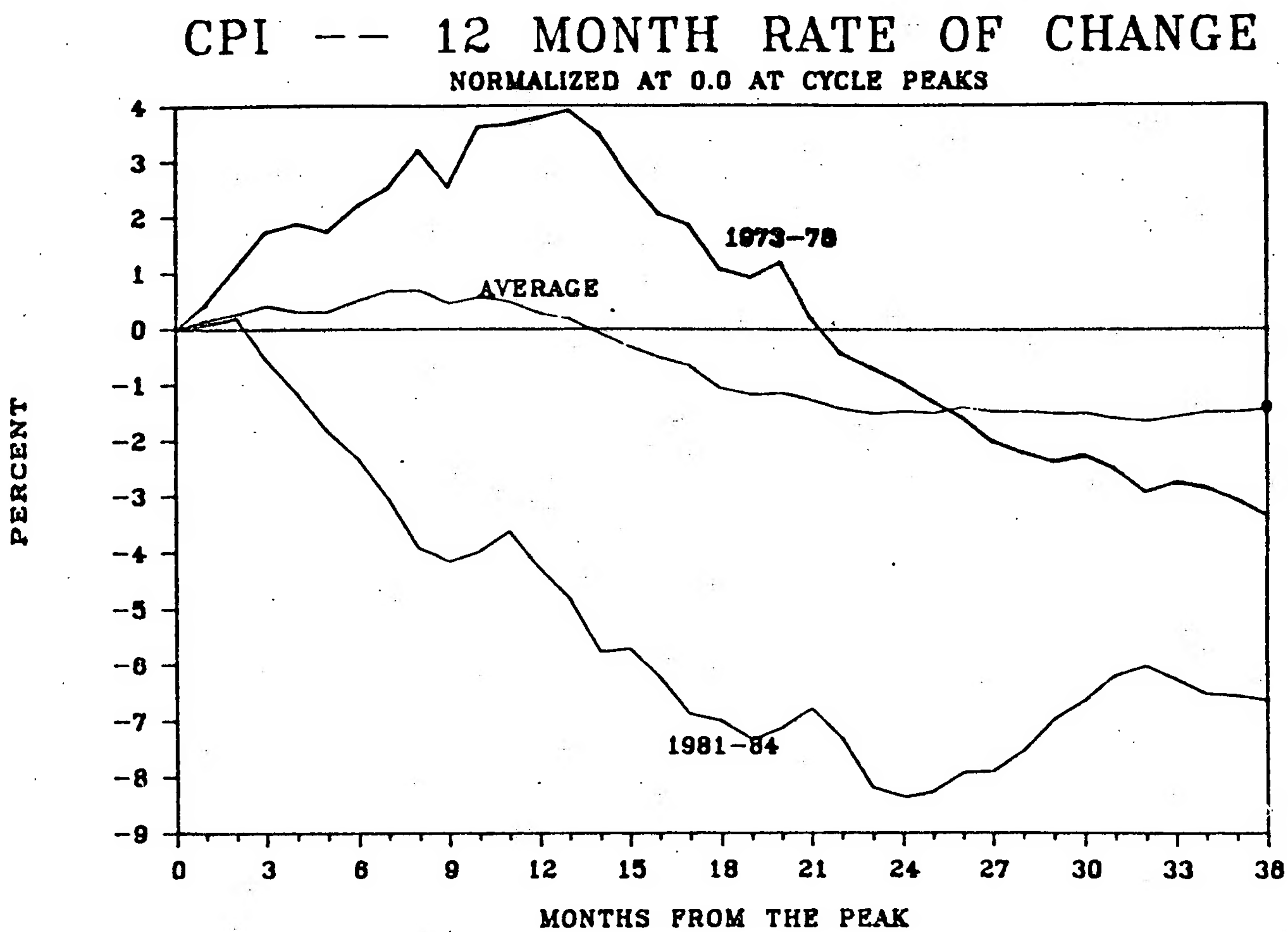
-- The stage we are in in the business cycle.

-- The rising value of the dollar.

Inflation Patterns Over the Cycle

o Typically, inflation continues to rise even after a recession has begun. It takes some time for the economy to weaken enough to cause inflation to decline.

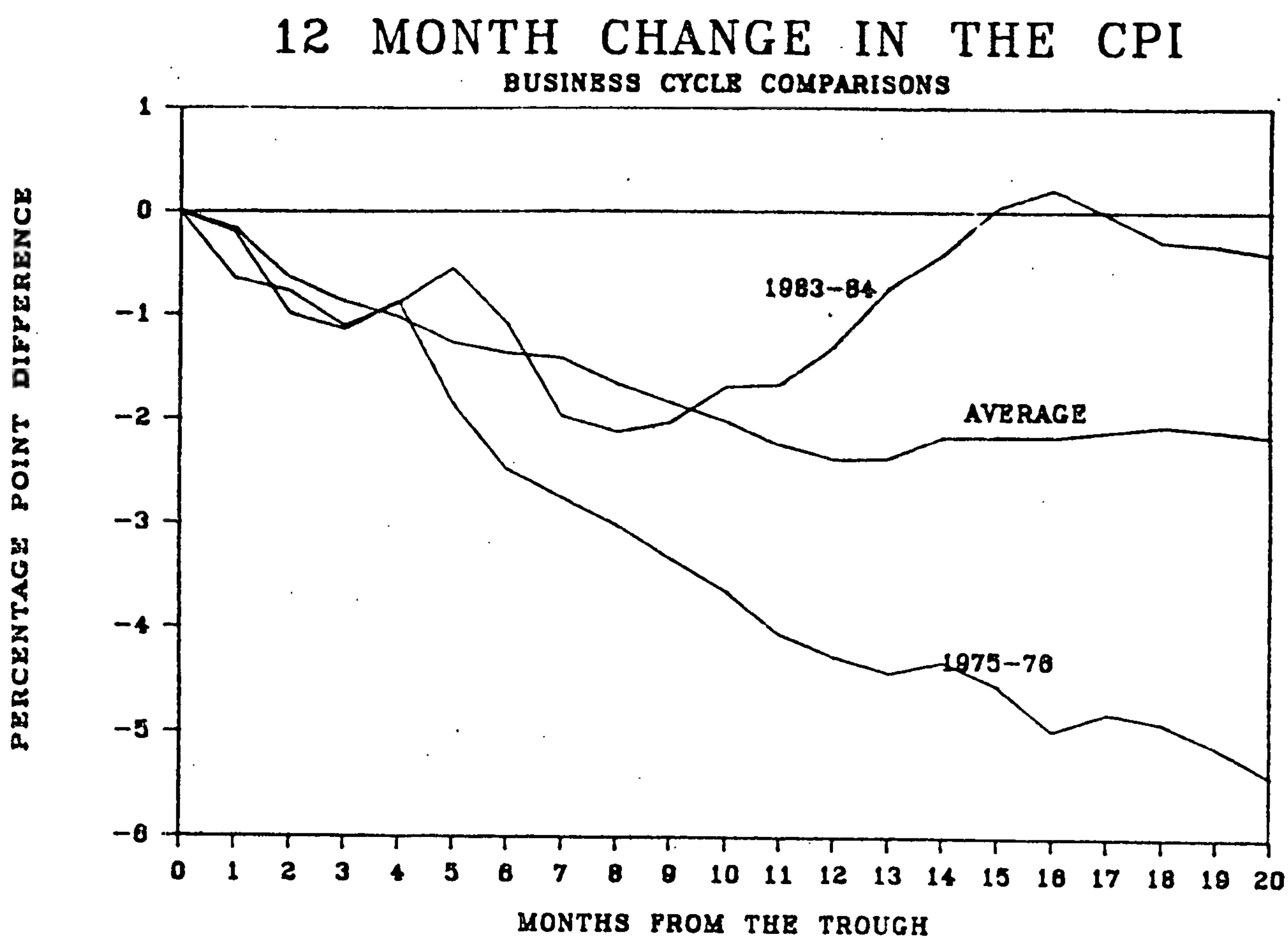
o This pattern did not emerge in the recent recession, inflation was already declining when the recession began.



o Certainly the major reason that inflation fell so quickly in the recent recession is that there was virtually no recovery from the 1980 recession. In fact, there was almost a continuous recession from January 1980 to November 1982.

o It is also typical for inflation to continue to fall (or not to rise) throughout the year and a half after the trough of the recession.

o In the most recent recovery, however, the CPI has begun to rise after less than a year of recovery and other inflation indicators stopped a clear decline at about that time.



- This strongly suggests that we have now gained all of the inflation benefits that will come from the monetary restraint of 1981 and the consequent weak economy of 1980-82.

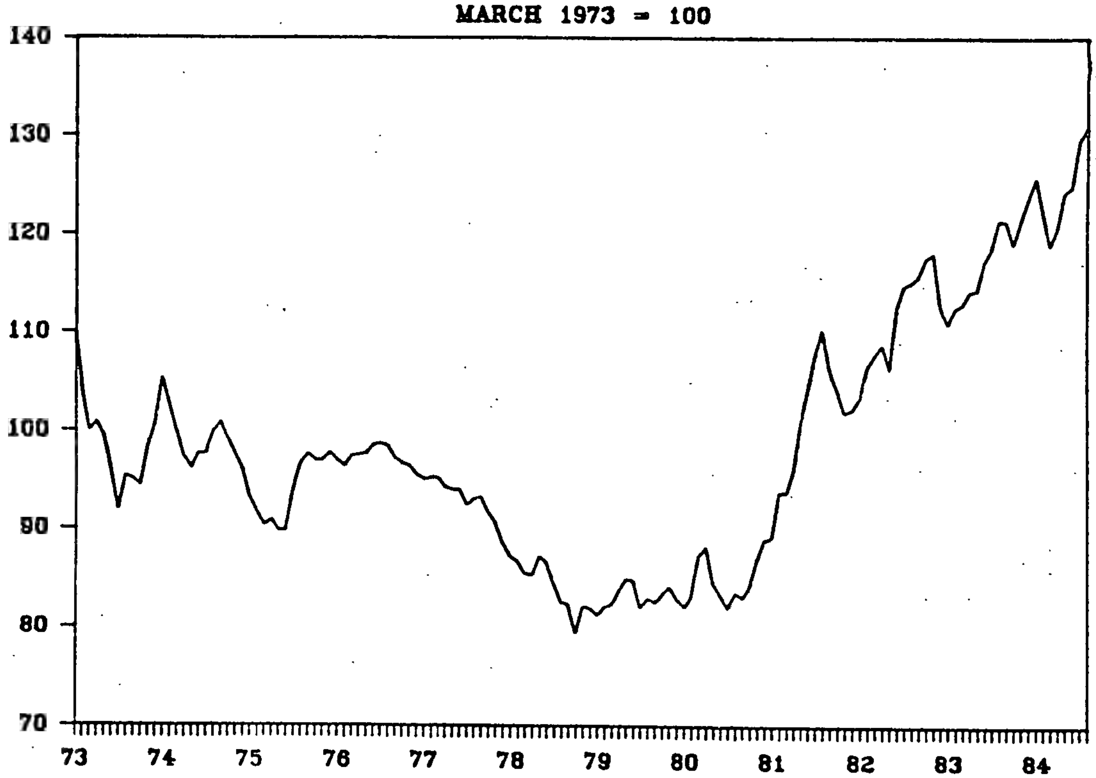
- A renewal of the decline in inflation, or even a continuation of inflation at the current level, will require a steady decline in the growth rate of money over the next few years.

Recent Levels of Inflation and the Rising Dollar

- By 1981 the rise in the real value of the dollar that began in late 1980, had fully offset the decline of the dollar during the late 1970s, and since early 1982 the dollar has risen another 30%.

REAL TRADE WEIGHTED DOLLAR

MARCH 1973 = 100



- o The real value of the dollar has a direct impact on the real price of imported commodities. If the real value of the dollar rises, the real cost of imports tends to declines.

- o A rise in the real value of the dollar resulting from United States policy changes or exogenous changes abroad can be a favorable inflation shock much like the oil price increases in the 1970's were unfavorable price shocks.

- o In fact, the almost 50% rise in the real value of the dollar is comparable in size to the oil price shock of 1979.

- o Ignoring offsetting changes in monetary policy, an exogenous 10% rise in the real value of the dollar will, with a lag, reduce the increase in the CPI by 1 to 1.5 points.

  - -- Since imports comprise about 10% of GNP, a 10% rise in the real value of the dolar initially tends to lower the CPI by 1%.

  - -- Importers tend to capture some of the price fall by raising the foreign price of the imported good laeving only about a 0.5% initial fall in the CPI.

  - -- A further drop of 0.5 to 1.0 in the CPI occurs more slowly as domestic prices rise less in order to compete with imports.

- o Consequently, the recent rise in the real value of the dollar (8% over the last year) on top of the dramatic previous rise may have lowered the inflation rate over the period 1981-84 by about 8 points and over the most recent year by about 1 percentage point.

- o This means that unless the dollar keep rising, the inflation problem we face now may be more on the order of 5% than 4%.

- o Further, it may be that part of the rise in the dollar has been due to expectations that we would pursue policies to further lower inflation; if those policies are not carried out such expectations may change and the dollar could fall adding to inflationary pressures.

CM-111

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

August 31, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

From: Beryl W. Sprinkel Beryl W. Sprinkel

Subject: The Outlook for the Economy and Monetary Policy

There are increasing signs that the pace of the economic expansion is moderating. This is generally good news for the financial markets. Early in the year there was widespread concern in the financial markets that the economy was growing so rapidly that an acceleration of inflation was inevitable. Those fears helped push long-term interest rates up between February and June. There was also a general expectation in the financial markets that these same concerns about rapid real growth and inflation would lead the Federal Reserve to tighten monetary policy. This speculation put upward pressure on short-term interest rates as well.

As the recovery continued into the summer and the price indices showed no significant acceleration of inflation, fears about future inflation subsided appreciably. Most surveys of inflation expectations have improved dramatically over the summer; one survey taken in June and again in August shows a sharp decline in inflationary expectations over all time horizons. The improvement in inflation expectations is reflected in a decline in long-term interest rates of about 100-150 basis points since late June/early July.

Inflationary concerns have also been allayed by the fact that money growth has been well-behaved so far in 1984. Relative to the fourth quarter 1983 average, M1 grew at an annual compound rate of 6.5% through July; with the exception of a few weeks in the March/April period, the level of M1 has generally remained within the upper half of its target range. During the first half of the year the concern about accelerating inflation and the speculation about Fed tightening (and the resultant effects on interest rates) would have been heightened considerably, if money growth had been higher and/or above its target range. In contrast, moderate and relatively stable money growth helped contain these expectations effects on interest rates.

The decline in long-term rates over the past two months has not been matched by a decline in short-term rates. This has led to some flattening of the yield curve over the summer.

Many analysts have attributed the failure of short rates to fall to the strength of business demand for credit and risks associated with problem financial institutions, as well as speculation about Fed tightening moves.

Earlier in the year, most private analysts were forecasting rising interest rates throughout 1984. Over the summer, more and more private forecasters began foreseeing stable, or modest declines, in rates during the second half of 1984. This change in outlook primarily reflects the downward adjustment in inflation expectations, evidence that the rate of economic expansion is moderating, and initial signs that the growth of private credit demand may be abating.

We should expect -- and welcome -- some slowing in the pace of economic activity. The declines in the index of leading indicators in June and July are foreshadowing a deceleration in the pace of economic recovery. If money growth continues to be moderate, inflation expectations should continue to adjust downward as the real economy settles into a sustainable rate of expansion. In addition, a moderation in the rate of economic growth can be expected to relieve some of the upward pressure on short-term interest rates.

In short, most of the worst-case scenarios that were potential threats to the economy earlier in the year have generally not materialized. While the economic expansion appears to be slowing down, there is no indication of an unacceptable slowdown, or decline, in economic activity as some had foreseen. While we can expect some acceleration in the rate of inflation -- and the Administration and the Federal Reserve must be vigilant to the threat of inflation -- wage and price pressures appear to remain subdued at the present time. While important progress has been made on the international debt situation, it, along with the financial difficulties of some major financial institutions, are important risks to continued economic growth and stability.

The major risk associated with monetary policy continues to be related to the operating procedures of the Federal Reserve. As we have discussed on many previous occasions, the Fed's day-to-day operating procedures are functionally equivalent to controlling the Federal funds rate. While this procedure may, as it has over the past six or eight months, result in appropriate money growth, the relationship between the Federal funds rate and money growth is generally not reliable or predictable.

Historically the Federal Reserve has failed to adjust its Federal funds rate target enough, or quickly enough, as market pressures on interest rates change. Thus the Fed lags behind and thereby resists market pressures on interest rates in either direction; the result is prolonged periods of too much or too little money growth. If there are downward market pressures on interest rates which the Fed does not recognize or act upon, it

will be in a position of propping rates up; the result is inadequate reserve and money growth. Conversely, if the Fed resists upward interest rate pressures in the market, the result is excessive reserve and monetary expansion. This is the source of what has historically been a highly procylical monetary policy in the U.S., which has alternatively over-stimulated the economy during expansions and exaggerated, if not caused, economic downturns.

Despite the relatively good performance of the monetary aggregates this year, these risks persist because the Federal Reserve's approach to policy implementation has not changed.